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# JAPAN'S FISCAL POLICY

## Summary

When Tokyo announces a new budget, Washington listens. It hasn't always been so, of course. Only a few years ago Japan's economy was so small that even major changes in government spending or taxes had virtually no effect on the U.S. economy. In fact, government spending and taxes still have a much larger influence westward across the Pacific than in the other direction, and Japan's tremendous interest in the U.S. government budget deficit reflects this orientation. Increasingly, though, U.S. officials are letting the Japanese know that how they spend government yen matters to Washington. This might appear peculiar since the funds represent taxes paid by Japanese firms and individuals and government expenditures in Japan. Still, the interest in this apparently internal matter is well-placed. A close look at the Japanese budget reveals a fiscal policy that recognizes Japan's international responsibilities, but that might leave some Americans wondering whether Tokyo could do still more.

## An International Perspective

It's easy enough to see some of the ways foreign trade matters to the American economy. When a Detroit auto worker loses his job, he blames foreign competition. The wheat farmer is at least as sophisticated; a weak dollar helps his product find a market overseas. Each may also believe, rightly or wrongly, that actions by foreign governments may influence his ability to earn a living by making it harder or easier to compete against products from those foreign countries. He is right, in more ways than he realizes. Not only do

product-specific measures like subsidies or tariffs have the potential to really throw American workers for a loop, but foreign government actions that appear to affect only that economy may have an even greater impact.

Fiscal policies -- changes in government spending and taxes leading to changes in the amount of goods and services produced in the economy -- are a case in point. The effect of American policies on Japan is the easiest to see and has received the most publicity, although the process works, with less force, in the opposite direction. For instance, since at least 1981 the United States has reduced federal taxes relative to government spending, with the result that it faces much larger budget deficits that must be financed somehow. If the government, or anyone else, spends more than it takes in someone somewhere has to do the reverse; there has to be saving.

What many feared when the 1981 tax cuts were enacted was that business firms would be crowded out of the capital markets by government borrowing to replace the lost tax revenues and that the increased budget deficits would be matched by smaller levels of corporate spending. That may well have happened to some degree. Of course, it would have been possible for more government borrowing to be offset by increased household saving, but as generally expected, Americans went right on spending.

Help, if that's the word, came from a somewhat unexpected source: the Japanese household, which produced much more than it spent, allowed Japan to sell abroad more than it bought. These savings, in effect, have financed part of the U.S. budget deficit, leading to the so-called twin deficits in trade and government spending. If the Japanese government should spend more -- pursue an expansionary fiscal policy -- that would keep some of the savings at home, and slow the trans-Pacific flow of funds. That would in turn mean that the government here would have to finance its deficit by outbidding corporations and households for domestic funds, sending overall interest rates higher in the process. Putting it all together, higher Japanese government spending could make it harder for Americans to buy a new house; reducing the trade deficit could also increase the income and job security of Detroit's auto workers.

All these conclusions depend on American and Japanese government behavior and saving decisions. For example, Table 1 shows that the U.S. saving rate is much lower than Japan's and lower than most, but not all, members of the Organization for Economic Cooperation and Development. Compared to net household saving data, a frequently used measure that shows the United States to be in an even less favorable position, gross saving -- the measure used in the table -- includes corporate saving in the form of consumption of fixed capital. It is the amount available for public and private investment and international capital flows. By this measure, the United States manages to beat out only Greece, Belgium, Iceland and Denmark among the 22 OECD countries surveyed in 1985.

Japan's savings put it at the top of the OECD countries. High Japanese savings, low American savings and high U.S. government spending have led to increased Japanese capital flows into the United States, as reflected in the

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current account deficit. Japan is, of course, not the only contributor, a number of other major countries also run bilateral surpluses with the United States.

Table 1: Gross Saving as a Percentage of GNP

| | 1970 | 1975 | 1980 | 1985 |
|---|---|---|---|---|
| United States | 18.3% | 18.1% | 19.2% | 16.5% |
| Japan | 40.2 | 32.3 | 31.1 | 31.4 |
| West Germany | 28.1 | 20.9 | 21.8 | 22.2 |
| France | 26.2 | 23.0 | 22.2 | 18.0 |
| United Kingdom | 21.9 | 15.5 | 18.4 | 19.2 |
| Italy | 24.2 | 20.1 | 22.5 | 17.7 |
| Canada | 21.2 | 21.1 | 22.9 | 18.6 |
| Other OECD Countries* | 26.2 | 23.5 | 21.6 | 21.5 |
| Total OECD | 23.4 | 21.5 | 22.0 | 20.2 |

*Includes Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

Source: Organization for Economic Cooperation and Development

Of course, if the government of Japan borrowed more, the savings would be absorbed internally to finance the budget deficit. While in the late 1970s and early 1980s government borrowing as a percent of the gross national product was higher in Japan than in the United States, that is no longer true (see Table 2). Most of the large OECD countries surveyed have managed to reduce government deficits slightly since 1982, but Tokyo appears to have been the most successful.

There is another possibility. Private investment could absorb the savings in Japan that the government does not use. While such investment has been reasonably high, it has not been enough to overcome the other effects. The data for fiscal 1987 are not yet available, but in FY 1986 the effect of household savings was very apparent. As Table 3 shows, it was large enough to finance part of corporate investment and the government deficit, with lots left over for overseas capital flows.

The data in Table 3 do not permit the easy conclusion that if the government deficit had been larger, there would have been a one-to-one reduction in the current account surplus. The whole economy would be affected by such an action and all the figures in the table would end up at least slightly different. It is probable, though, that the surplus would decline significantly, just as the U.S. budget and trade deficits have risen almost exactly in tandem.

Table 2: General Government Fiscal Balances

(surplus or deficit (-) as percent of nominal GNP or GDP)

| | | | | | | OECD Estimate | |
|---|---|---|---|---|---|---|---|
| | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
| United States | -3.5% | -3.8% | -2.8% | -3.3% | -3.5% | -2.4% | -2.4% |
| Japan | -3.6 | -3.7 | -2.1 | -0.8 | -0.9 | -1.2 | -1.1 |
| West Germany | -3.3 | -2.5 | -1.9 | -1.1 | -1.2 | -1.7 | -2.3 |
| France | -2.8 | -3.2 | -2.7 | -2.9 | -2.9 | -2.8 | -2.7 |
| United Kingdom | -2.3 | -3.6 | -3.9 | -2.9 | -2.6 | -2.1 | -1.9 |
| Italy | -11.3 | -10.7 | -11.5 | -12.3 | -11.2 | -10.3 | -10.0 |
| Canada | -5.9 | -6.9 | -6.6 | -7.0 | -5.5 | -4.4 | -3.3 |
| Other OECD Countries* | -4.8 | -5.1 | -4.2 | -4.1 | -3.4 | -2.9 | -2.9 |
| Total OECD** | -4.0 | -4.2 | -3.4 | -3.4 | -3.3 | -2.7 | -2.6 |

*Other OECD countries in this sample include Australia, Austria, Belgium, Denmark, Finland, Greece, Netherlands, Norway, Spain and Sweden.

**1982 GNP/GDP weights and exchange rates.

Source: Organization for Economic Cooperation and Development

Table 3: Capital Supply and Use in Japan, FY 1986

(in trillions of yen)

| | Savings and Capital Supply | Capital Formation | Imbalance |
|---|---|---|---|
| Households | Y49.4 | Y16.9 | Y32.5 |
| Nonprofit Institutions Serving Households | 1.4 | 1.2 | 0.2 |
| Government | 15.2 | 18.8 | -3.7 |
| Corporations | 39.3 | 55.6 | -16.3 |
| Statistical Discrepancy | | | 1.5 |
| Equals Surplus of Funds | | | 14.2* |

*The surplus of funds approximately equals the current account surplus. At Y159.83=$1.00, the average exchange rate in FY 1986, the surplus of funds was $88.8 billion.

Source: Calculated from data provided by Economic Planning Agency.

Effects of Fiscal Policy

Exactly how fiscal policies play out is a highly controversial area of economics. For one thing it is possible that a given action has a different effect depending on the existing state of the economy and that the effects differ by country. One factor is the government's share of the economy. The larger its role, the more potent fiscal policy is likely to be. According to OECD data, Sweden had the largest governmental sector of the 18 industrial countries surveyed in 1985 at 64.5 percent of gross domestic product. Switzerland had the smallest figure at 30.9 percent. The average for the 18 was 41 percent. The data show Japan and the United States had among the smallest governmental sectors, 32.7 percent and 36.7 percent, respectively. Japan and the United States showed a pattern of convergence between 1966 and 1980, but since 1980 the gap has been widening again.

Of course, outlays are only part of the picture. As might be expected from the earlier discussion, taxes have been higher relative to expenditures in Japan. The United States had the lowest overall tax burden among the 18 OECD countries at 31.1 percent of GDP in 1985; Japan was right behind at 31.2 percent. Japan's ratio climbed to the highest point in at least 20 years and the United States was close to its highest level.

These outlay and tax figures suggest that government has been getting larger by either measure in the past 20 years in both countries, especially Japan. But both countries are unusual in having comparatively small governments. The distinctive comparison in fiscal policy in the United States and Japan is not the level of government spending or taxes, but the difference between them: the budget deficit. Furthermore, the relative size of the two deficits has very obvious implications for economic and political relations through the effects on the bilateral current account balance.

The effects of fiscal policy are complex and controversial. Increased government spending or reduced taxes create a new source of demand in the economy, either as the government goes into the market to buy the labor and goods it wants, or else as consumers use their larger after-tax incomes to buy more. Additional increases may follow as the recipients in the first round of spending raise their own consumption levels. On the other hand, increased government expenditures could price other buyers out of the market. For example, if the government borrows to finance higher expenditures, it may push interest rates up and affect the interest-sensitive housing market. Or, government spending and/or tax cuts could ignite inflation, with adverse effects on the spending plans of those whose income increases fail to match the rate of price hikes.

The effects do not stop there. Increased government spending may result in more highways, parks or educational facilities that in turn will have their own effects on the economy, sometimes raising it further if the productive power of the economy is augmented. Or, this expenditure may improve the quality of life even if it does little to boost GNP.

Government spending, of course, has negative effects too. More government spending may crowd out investment by private firms that would have led to increased productive potential. If the government spending fails to do much to augment productive capacity itself, the result is a net loss. If government

spending is matched by higher taxes, individual incentives could be reduced as taxpayers see the rewards for their efforts shrink.

What is remarkable about all of these possible effects of government spending increases or tax cuts is that they generally work in the same direction when it comes to the current account. That is, higher expenditures may crowd private investors out of the capital markets, possibly reducing future productive capacity. Any source of additional domestic demand reduces savings for overseas capital flows and the reduced productive capacity may limit to some extent the future ability to produce more than is consumed domestically.

In other words, what the Japanese government does matters to Americans. No matter what one believes about how fiscal policy works its way through the economy, higher Japanese spending is likely to reduce the size of the U.S. trade deficit. If this spending is accompanied by more taxes, either through growth in the economy or explicit tax increases, the effect is likely to be milder since the government would be doing less to absorb excess savings.

It is this line of thinking that prompted the group of nations signing the Louvre Accord in February 1987 to urge Japan to significantly increase government spending in fiscal 1987 (ending March 31, 1988). Overall, Japan earmarked an additional Y4.1 trillion ($32.8 billion at Y125=$1.00) for expenditures, especially on public works, and implemented an estimated Y1.5 trillion ($12 billion) in personal income tax cuts for calendar 1987. Partly as a result, the Japanese economy has been growing rapidly and its current account surplus has been declining.

The future looks the same, according to the Japanese government. Private and public forecasters agree that the economy will grow significantly in the fiscal year that runs from April 1, 1988 to March 31, 1989 (see JEI Report No. 8A, February 26, 1988). The government expects 3.8 percent real growth in the face of net exports cutting 1 percentage point off the rate; the average private forecast calls for 3.7 percent growth. There is also widespread agreement that the current account surplus will continue to shrink, with a government projection of $72 billion in FY 1988 compared to an actual $94 billion in FY 1986 and an as-yet unannounced intermediate level in FY 1987.

The Japanese Budget

Like the economic outlook, Japan's budget is developed in December of the previous calendar year and the two are closely related. To Americans, the Japanese budget process appears strikingly different. Although the opposition parties typically do not think much of what the government proposes, they are rarely able to change the budget or delay it significantly. This year the budget went into effect April 8, eight days after the start of the fiscal year in the same form in which it was presented to the Diet in January. In comparison to the American budget process, which involves numerous continuing resolutions, congressionally mandated changes and threatened (and sometimes actual) partial governmental shutdowns and the like, the Japanese process seems remarkably tidy.

If the approval process is relatively simple, the budget itself is anything but. Although the term usually refers to the general account budget, that budget accounts for less than half of total central government expenditures. The rest is in 38 special accounts earmarked for special purposes such

as the government's printing bureau. Complicating things further, some but not all the special account funds come from the general account. In addition, there are various semi-independent public organizations such as the Japan Development Bank that have their own budgets. They, too, may overlap with the general account.

Table 4 shows how these three kinds of budgets have varied in size in recent years. In total, the general account budget is a little over one-quarter of the total before subtracting the overlap. A comparison of revenues would show about the same result.

Table 4: General Account Budget, Special Accounts Budgets and Budgets of Government-Related Organizations

(initial expenditures in billions of yen)

| | FY 1972 | FY 1977 | FY 1982 | FY 1987 |
|---|---|---|---|---|
| General Account | Y11,467.8 | Y28,514.3 | Y49,680.8 | Y54,101.0 |
| Special Accounts | 20,510.0 | 56,363.7 | 106,942.8 | 149,138.0 |
| Government-Related Organizations | 8,136.5 | 16,552.5 | 23,582.1 | 5,276.1 |
| Subtotal | 40,114.3 | 101,430.5 | 180,205.8 | 208,515.1 |
| Overlap | 15,903.2 | 39,405.6 | 77,613.5 | 101,941.0 |
| Net | 24,211.1 | 62,024.9 | 102,592.3 | 106,574.1 |

Source: Ministry of Finance

Complicating matters still further is the Fiscal Investment and Loan Program, sometimes called the second budget. Most of its funds come from a single source, the Trust Fund Bureau Special Account, which in turn is financed mainly by postal savings. In many instances, FILP is essentially a description of how these funds are funneled into government financial institutions such as the Japan Development Bank, which in turn lends them to the public. FILP involves neither taxes nor government spending in the normal sense.

The Economic Planning Agency has to sort all this out when it develops national income statistics showing the contribution of government. It divides the government component of the gross national product into government consumption and government investment. In 1984, the most recent year such data are available, 75 percent of the central government's consumption flowed through the general account and the remainder through special accounts and government enterprises; only about 5 percent of government investment spending was attributable to the general account.

Generally speaking, then, the general account represents government consumption, and the other accounts government investment. Since EPA has found

that both government consumption and government investment are important, it suggests a need to look at more than the general account. Simply adding all the budgets together, however, would vastly overstate the fiscal thrust of government since, as noted above, they overlap. It is difficult then to infer fiscal policy from any set of budget figures. As a first approximation, most observers concentrate on the general account, with some attention to FILP, the procedure followed here.

FY 1987 Budget - The general account budget for fiscal 1987 demonstrated some of the twists and turns of Japanese fiscal policy. It was supplemented twice, making it one of postwar Japan's more complicated budgets (see Table 5). The first supplemental budget was the one that got most of the publicity. Of the Y2 trillion ($16 billion) total, Y1.4 trillion ($11.2 billion) went to public works and another Y0.4 trillion ($3.2 billion) was transferred to the industrial investment special account, one of the funding sources for FILP, suggesting a substantial commitment to capital projects.

Table 5: General Account Budget, FY 1987-FY 1988

(in trillions of yen)

| | Initial FY 1987 | After First Supplemental | After Second Supplemental | Initial FY 1988 |
|---|---|---|---|---|
| Budget | Y54.1 | Y56.2 | Y58.2 | Y56.7 |
| Bonds Issued | 10.5 | 11.9 | 10.5 | 8.8 |
| Bond Dependency Ratio | 19.4 | 21.1 | 18.1 | 15.6 |

Source: Ministry of Finance

FY 1988 Budget - Tables 6 and 7 detail the changes for fiscal 1988. Large increases are scheduled for defense and economic cooperation, but cuts or small raises are slated for major counter-cyclical expenditures such as social security, reflecting the government's optimism about the direction of the economy. The net effect is a FY 1988 general account budget 4.8 percent larger than the initial FY 1987 budget, but 2.6 percent less than the final version. Of course, the fiscal year is still young and the current budget could be supplemented as well.

Taxes are scheduled to rise enough with the growth of the economy to allow the government to cut its dependence on deficit financing from 19.4 percent in FY 1987's initial budget to 15.6 percent this year. The figures in Table 7 reflect neither tax reform nor tax reductions, both of which are possible. Recently released data for 1987 and early 1988 suggest tax revenues in FY 1988 are likely to be higher than shown in the Table, primarily because of continuing strong economic growth and a larger-than-expected FY 1987 base on which to build. If so, the deficit to be financed with bonds will be correspondingly lower unless there is a tax cut.

Table 6: General Account Expenditures, FY 1986-FY 1988

(initial expenditures in billions of yen)

| | FY 1986 | FY 1987 | FY 1988 | Percent Change FY 1987-FY 1988 |
|---|---|---|---|---|
| National Debt Service | Y11,319.5 | Y11,333.5 | Y11,512.0 | 1.6% |
| Transfers to Local Governments | 10,185.0 | 10,184.1 | 10,905.6 | 7.1 |
| NTT Stock Sale Proceeds to Special Account | 0.0 | 0.0 | 1,300.0 | n.a. |
| Discretionary Expenditures | 32,584.0 | 32,583.3 | 32,982.1 | 1.2 |
| Social Security | 9,834.6 | 10,089.6 | 10,384.5 | 2.9 |
| Education and Science | 4,844.5 | 4,849.7 | 4,858.1 | 0.2 |
| Pensions | 1,850.1 | 1,895.6 | 1,879.8 | -0.8 |
| Defense | 3,343.5 | 3,517.4 | 3,700.3 | 5.2 |
| Public Works | 6,223.3 | 6,082.4 | 6,082.4 | 0.0 |
| Economic Cooperation | 623.2 | 649.2 | 682.2 | 5.1 |
| Small Business Assistance | 205.2 | 197.3 | 195.2 | -1.1 |
| Energy Support | 629.7 | 495.2 | 461.6 | -6.8 |
| Food Agency Account | 596.2 | 540.6 | 448.2 | -17.1 |
| Miscellaneous | 4,083.7 | 3,916.3 | 3,939.8 | 0.6 |
| Reserves | 350.0 | 350.0 | 350.0 | 0.0 |
| Total | 54,088.6 | 54,101.0 | 56,699.7 | 4.8 |

Source: Ministry of Finance

Table 7: General Account Revenues, FY 1986-FY 1988

(initial revenues in billions of yen)

| | FY 1986 | FY 1987 | FY 1988 | Percent Change FY 1987-FY 1988 |
|---|---|---|---|---|
| Tax and Stamp Revenues | Y40,560.0 | Y41,194.0 | Y45,090.0 | 9.5% |
| Other Revenue Sources | 2,582.6 | 2,406.0 | 1,468.7 | -39.0 |
| NTT Stock Sale Proceeds | 0.0 | 0.0 | 1,300.0 | n.a. |
| Public Bonds | 10,946.0 | 10,501.0 | 8,841.0 | -15.8 |
| Total | 54,088.6 | 54,101.0 | 56,699.7 | 4.8 |

Source: Ministry of Finance

FILP is scheduled for an increase of 9.4 percent over the initial level for FY 1987 (see Table 8).

Table 8: Fiscal Investment and Loan Program Outlays, FY 1987-FY 1988

(initial expenditures in billions of yen)

| | FY 1987 | FY 1988 | Percent Change |
|---|---|---|---|
| Housing | Y6,328.2 | Y6,921.5 | 9.4% |
| Other Social Infrastructure | 3,998.7 | 4,450.9 | 11.3 |
| Welfare | 627.7 | 661.8 | 5.4 |
| Education | 784.1 | 637.6 | -18.7 |
| Small Business | 3,985.6 | 4,030.6 | 1.1 |
| Agriculture | 907.8 | 979.4 | 7.9 |
| Land Conservation and Disaster Work | 493.0 | 409.8 | -16.9 |
| Roads | 2,363.0 | 2,512.1 | 6.3 |
| Transportation and Communications | 2,264.1 | 2,229.9 | -1.5 |
| Regional Development | 657.7 | 652.2 | -0.8 |
| Industry and Technology | 630.9 | 687.2 | 8.9 |
| Foreign Trade and Economic Cooperation | 690.5 | 1,171.0 | 69.6 |
| Self-Managed Investments* | 3,350.0 | 4,270.0 | 27.5 |
| Total | 27,081.3 | 29,614.0 | 9.4 |

*Beginning in FY 1987 some of the sources of funds for the Trust Fund Bureau were given limited authority to manage investments themselves.

Source: Ministry of Finance

Impact of Fiscal Policy in FY 1988

Using the figures from the government's economic outlook, government spending is scheduled to increase 2.2 percent in nominal terms or 1.7 percent in real terms in FY 1988. Because of the various government budgets, and the FY 1987 supplemental budgets, these latter figures give a better indication of the actual impact of government spending on the economy than the more widely publicized increases of 4.8 percent in the general account and 9.4 percent in the FILP.

Implicit in the outlook for the current fiscal year is a diminishing role for fiscal policy. In FY 1987 EPA estimates that the public component contributed 0.6 percentage point of overall real growth, which is likely to be close to 4 percent. In FY 1988 it calculates the government contribution at 0.3 percentage point and overall inflation-adjusted growth at 3.8 percent. Clearly the outlook is assuming a surge in private demand.

Government net borrowing is likely to decrease as a percentage of GNP. The OECD estimates that the deficit will decline from 1.2 percent in calendar 1987 to 1.1 percent in 1988. Consistent with the budget figures showing a diminished reliance on bonds, this suggests the importance of expanding private

demand to either reduce savings or to absorb the surplus that would otherwise end up as capital flowing overseas. Early indications are that the government will get its wish and the private sector will in fact take up the slack.

Conclusion

Usually, but not always, the Japanese government has assigned fiscal policy a relatively small role, in keeping with the fact that the government does relatively little spending compared to other industrialized countries. In recent years Tokyo has moved successfully to restrain deficit spending, reducing the impact of fiscal policy still further. The smaller deficits have prevented government spending from absorbing much of Japan's enormous savings, which instead have gone to finance part of the U.S. budget deficit and have pushed up the bilateral trade imbalance at the same time. If the fiscal 1988 budget is any guide, little help is likely to be forthcoming in the foreseeable future in this regard from Japanese fiscal policy. It will be up to the United States to solve the problems of the twin deficits itself.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.